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TAGS: ECON EFIN EUN
SUBJECT: Economic Forecast for Germany: Waiting for a Recovery Abroad to Spark Recovery, but Reform Debate Shows Something Happening Domestically

T-IA-F-03-0052

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¶1. (SBU) Summary: The German economy is expected, at best, to stagnate in 2003. Since GDP declined by -0.3% in the first half of the year compared to the previous half-year, positive GDP growth in 2003 is no longer achievable. Driven by improving net exports, German economy will pick up in 2004, reaching seasonally-adjusted 1.3% GDP growth. Domestic demand will increase only moderately, despite the Government's big reform package. The key limiting factor for domestic demand in Germany is lack of confidence by consumers and producers. Germany will breach the Stability Pact's 3% ceiling in both 2003 and 2004. An improvement of the state's financial situation can be expected only in 2005, after economic recovery has gathered momentum and the reform package begins to yield cost savings. While prospects beyond the forecast horizon are not overwhelming, something is stirring in Germany that might just signal the economy is coming out of its three year hibernation.

Prospects for 2003/04: Waiting for Recovery Abroad (again)!

¶2. (SBU) In 2003, the German economy is expected to stagnate at best, given the seasonally-adjusted -0.3% decline in GDP in the first half of the year, compared to the last half of 2002. Driven by improving net exports, German economy will pick up in 2004, reaching seasonally-adjusted growth of 1.3% GDP. 2004 growth on a non-seasonally adjusted basis is estimated at 1.8% due to four more working days in the calendar year.

Bad Starting Point: Germany in Recession!

¶3. (SBU) Germany is now in a recession: German GDP fell in the second quarter for the third time in a row, this time by a real, seasonally and calendar adjusted -0.1% compared to the first quarter.

¶4. (SBU) The decline of GDP was mainly due to a decrease in exports (-2.3%), which was much stronger than the drop in imports (-1.1%), causing a reduction of net exports. The resulting negative contribution to economic growth (-0.5 percentage points) could not be completely compensated by the positive growth contribution of domestic demand (+0.3 percentage points). The strong Euro against the US dollar, the disruption of production in the automobile industry triggered by strikes in East Germany and modest growth in the world economy combined to dampen German exports. The reduction of imports was a counter movement to the strong increase at the beginning of the year due to rising oil demand in view of the threatening Iraq war. The fall in imports was mitigated by the strong Euro.

However, Indicators and Financial Markets are Encouraging

¶5. (SBU) The ZEW indicator, in an upward trend since December 2002, recently recorded hefty increases and is therefore well above its historical average. The more highly regarded ifo index has also continued to increase, now for the third month in a row. The development of both indicators merely signals improving business expectations. The current economic situation is still assessed as poor by the majority of those interviewed. The German Economic Sentiment Indicator, developed by the EU, shows a similar picture: its trend line is a weak positive despite deterioration in July. Increasing share prices on the German stock market reflect the optimistic expectations as well -- within three months, the DAX index increased by 16.6% and the TecDAX rose by

35.9%.

... Though Real Data is Disappointing,

¶6. (SBU) Favourable indicators are not yet backed by fundamental data. Industrial production and industrial orders decreased significantly in the second quarter of ¶2003. Nor are the improving July numbers meaningful, since they mainly reflect compensating up ticks for the production losses in June caused by strikes in East Germany.

... Confidence is Still Missing,

¶7. (SBU) The key problem for modest domestic demand in Germany is still the lack of confidence, both for consumers and producers.

¶8. (SBU) Consumer confidence increased initially in the period after announcement of the government's plan to advance the third step of the income tax reform. However, after the summer holidays, as consumers heard more about the government's plans to cut subsidies and tax privileges, the health minister's decision to increase the financial burden for the insured and to further increase pension contributions, any glimmer of confidence has been destroyed. Consumer uncertainty is reflected to some extent by significant fluctuations in retail sales. It is not expected that consumers will regain confidence in the near future so long as unemployment remains high and uncertainty persists regarding changes in the existing social system.

¶9. (SBU) For their part, producers are awaiting definitive implementation of the proposed reforms. Until then, they are unlikely to invest in additional capital stock. The reforms would release entrepreneurs from some mandated payments, decreasing payroll costs. The question remains, however, whether the Bundestag and the Bundesrat will approve the reform plans. Apart from that, producers hope for more reforms to follow.

... Negative Forecasts Risks Have not Vanished, but are Weakening,
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¶10. (SBU) Risks on the downside still exist, but with lower weights.

¶11. (SBU) The risk of deflation in Germany, the top subject among German economists, has decreased due to the high oil price and the easing of the euro/US dollar valuation, both leading to rising producer prices. For this reason, annual CPI in 2003 is expected to be higher than initially forecast, reaching 1.1% instead of 0.8%. For 2004 prices should increase 0.9% on average due to low advances early in the year, gradually accelerating with economic recovery.

¶12. (SBU) The credit crunch risk has weakened as well. There are indications that German banks have begun to relax their tightening of credit standards. Moreover, credit demand is expected to increase as the German economy recovers.

¶13. (SBU) The German government has launched several reform plans, most of which will need the approval of the Bundesrat, the upper chamber of parliament, which is dominated by the opposition. There is risk that parts of the reform plans will be rejected by the Bundesrat. However, a total reform failure is unlikely, given cross-party working groups which were formed with the intention to work out compromises on reforms to achieve agreement.

¶14. (SBU) One higher downside risk threatening German recovery is weak eurozone growth. For example, important German markets like Italy and the Netherlands are also in a recession. France, too, is suffering from an ailing economy. In contrast, there is one upside risk factor that is looking better: the surprisingly good economic performance of the US economy.

... and the Government's budget Deficit Remains High

¶15. (SBU) Germany will breach the Stability Pact's 3% of GDP deficit ceiling this year with 3.9%. The financial misery is not yet under control, but consolidation measures are planned. At the moment, the German budget in 2004 appears likely to turn in a deficit of 3.8%. Even in the best case scenario --in which all planned consolidation measures are put into effect, tax revenues meet expectations, and the Government's forecast 1.8% real GDP growth materializes -- the deficit would only improve to 3.5% in 2004, according to our calculations.

¶16. (SBU) However, going forward the government's financial situation should improve significantly in 2005 as continued economic recovery will generate high tax revenues and subsidy reductions and Agenda 2010 reforms will begin to have positive effects on public finances for the first time.

Conclusion: Everything Stays as it was, Waiting for a Recovery Abroad,

¶17. (SBU) Germany's poor economic performance in the first half of the year and the lack of consumers' and investors' confidence will lead at best to stagnation of the German economy in 2003. For 2004, the June forecast of a non-adjusted 1.3% GDP growth is still valid, since the Government's reform package is not expected to have a big effect on real net income.

¶18. (SBU) The eventual recovery will be mainly driven by the export side, as in previous years. Private consumption will only increase by 0.9% due to several factors: (a) the savings rate will remain at the high level of 10.8% as a result of low confidence; (b) no significant change in the labor market is expected (moreover, unemployment benefits will be cut); (c) downward revision of GDP growth in 2003 will negatively affect gross income in 2004; (d) the benefits to consumers of bringing forward the third step of the income tax cuts will be partly counterbalanced by other costs and fees.

¶19. (SBU) The latter point requires some clarification. Implementing the 2003 tax cut, which had been postponed to 2004, and bringing forward the third step of the income tax cut scheduled for 2005 to 2004 will combine to decrease the introductory tax rate from current 19.9% to 15% and the top rate from 48.5% to 42%. This will release taxpayers from 22 bn euro in payments, of which 15.6 bn are due to the third step of the income tax reform. Not all of this will find its way into additional disposable income. Some of the measures that will mitigate the income benefits include (a) higher pension contributions (increase from 19.5% to 19.9% is expected); (b) consumer subsidy cuts (a reduction of tax privileges of about 5.5bn euro are planned - partially compensated by higher expenditures); and (c) a change in the health care system (lower contributions rates, but increased payments for coverage from own funds).

...but Something is Happening!

¶20. (SBU) Although prospects beyond the forecast horizon are not overwhelming, there is something going on in Germany. Should the government be successful in getting its program adopted, results, particularly on the budget front as well as on investment and possibly even consumer sentiment would be positive. The times of the "steady hand" are over. This is already good news. Sentiment indicators and market valuations also reflect improving prospects. Passage of the governments reform plans, coupled with improving expectations that a U.S. led global recovery is underway, are combining to increase the sense that Germany is finally on the way out of its three year stagnation.

Forecast- Germany
(Percent)

	2002 ACTUAL	2003 FORECAST	2004 FORECAST	---
GDP :	0.2	0.0	1.8	
CONSUMPTION:	-1.0	0.7	1.4	
GOV. CONSUMPTION:	1.7	1.1	1.7	
INVESTMENT:	-6.7	-1.7	1.4	
- MACH. & EQUIP.:	-9.1	-0.7	4.5	

- CONSTRUCTION:	-5.8	-3.6	-1.4
- OTHER INVEST.:	1.6	0.7	5.4
NET EXPORTS:	51.4	-17.5	2.6
- EXPORTS:	3.4	-0.2	3.1
- IMPORTS:	-1.7	2.7	3.2
NOM. GDP: (Euro Bill)	2110.4	2127.3	2165.6
CURRT. ACCT. (Euro Bill)	59.7	44	59
PRICES:	1.4	1.1	0.9
EMPLOYMENT (Thousands)	38,668	38,200	38,350
UNEMPLOYMENT (nat. definition)	4,060	4,500	4,560
UNEMPLOYMENT RATE (nat. def.)	9.8	10.9	11
TOTAL FISCAL BALANCE: (Pct. GDP)	-3.8	-3.9	-3.8

¶21. (U) This cable was coordinated with Embassy Berlin.

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